ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Knight | Analyst: Marion Mann DeJong | Bill Number: SB 85

Related Bills: See Legislative History | Telephone: (916) 845-6979 | Introduced Date: 12/07/98

Attorney: Doug Bramhall | Sponsor:

SUBJECT: VentureStar® Spacecraft & Launch Site Credit

SUMMARY

This provision would create a wage credit and property credit for the VentureStar® spacecraft and launch site (VentureStar® credits). The VentureStar® credits would apply to taxpayers under initial contract or subcontract to manufacture property for ultimate use in a VentureStar® spacecraft or launch site.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately. However, the bill specifies that it would apply to taxable or income years beginning on or after January 1, 2001, and before January 1, 2006.

LEGISLATIVE HISTORY

AB 2361 (1995/1996), AB 390 (1997/1998), AB 1779 (1997/1998), AB 2797 (Stats. 1998, Ch. 322).

PROGRAM HISTORY/BACKGROUND

The National Aeronautics and Space Administration (NASA) has been working in partnership with private industry to develop the next generation of space vehicles, known as reusable launch vehicles (RLVs).

The X-33 and X-34 programs were initiated in direct response to the National Space Transportation Policy with the primary goal of reducing NASA's launch costs. These programs provide the incremental technology development and demonstration and business planning that will help determine the appropriate approach to an operational launch system to reduce NASA's launch costs.

The X-33 program is a larger and more aggressive experimental flight program than the X-34. It combines business planning with ground and flight demonstrations of advanced structures, materials and propulsion system technologies. The X-33 program includes a half-scale experimental demonstrator that will begin flight testing in the summer of 1999.

The X-33 technology demonstrator is being developed by a team led by Lockheed Martin Skunk Works under cooperative agreement with NASA. The X-33 suborbital

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demonstrator will pave the way for a commercially developed, reusable space plane that Lockheed Martin calls VentureStar®. VentureStar® will be a single-stage-to-orbit (does not drop tanks and rocket boosters along its flight path), fully reusable space delivery system (similar to an airplane) that is scheduled to begin operations in 2004. Between flights the VentureStar® will simply undergo inspection, refueling, and reloading. There will be no components to remanufacture and reassemble. By reusing the entire vehicle, VentureStar® will have a dramatically lower cost of operations, thereby offering space transportation services at a much lower cost.

SPECIFIC FINDINGS

Existing **state and federal laws** generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a business or as investment property. The property must have a useful life of more than one year and includes equipment, machinery, vehicles and buildings but excludes land. Property is assigned to specific classifications related to the number of years of its useful life. The property then may be depreciated over the number of years of its useful life (recovery period).

Existing **state and federal laws** allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business (e.g., employee wages and benefits).

Existing **state law** allows taxpayers to use various credits against tax such as the Manufacturers' Investment Credit (MIC), economic development area[1] sales or use tax credits and hiring credits, and the Joint Strike Fighter (JSF) credits.

MIC

The MIC allows qualified taxpayers a credit equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California. A qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes in the Standardize Industrial Codes (SIC) Manual.

Sales or Use Tax Credits

The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified property for exclusive use in an economic development area (except an MEA). The amount of the credit is limited to the tax attributable to economic development area income.

Hiring Credits

A business located in an economic development area may reduce tax by a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated as an economic development area and must meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the economic

[1] Economic development areas include Enterprise Zones, the Los Angeles Revitalization Zone (LARZ), Local Agency Military Base Recovery Areas (LAMBRAs), Targeted Tax Areas (TTAs) and Manufacturing Enhancement Areas (MEAs).

development area and at least 50% must be performed inside the economic development area. The taxpayer may claim as a credit up to 50% of the wages paid to a qualified employee against tax imposed on economic development area income. The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (202% of the minimum wage for certain aircraft manufacturer employees within the Long Beach Enterprise Zone).

JSF Credits

For taxable or income years beginning on or after January 1, 2001, a wage credit and property credit is provided for taxpayers under initial contract or subcontract to manufacture property for ultimate use in a Joint Strike Fighter (the next generation strike aircraft weapon systems).

The JSF wage credit is equal to a specified percentage (50% for 2001, 40% for 2002, 30% for 2003, 20% for 2004 and 10% for 2005) of employee wages that are treated as direct costs under Section 263A of the Internal Revenue Code (IRC) allocable to property manufactured in this state for ultimate use in a JSF. The wages can be paid to new or existing employees whose services for the taxpayer are at least 90% directly related to the contract or subcontract to manufacture property for ultimate use in a JSF. The credit is limited to $10,000 per year, per employee, and is prorated for partial years.

The JSF property credit is generally patterned after the MIC. It is equal to 10% of the cost of qualified property. Qualified property means tangible personal property (IRC Section 1245(a)(3)(A)), and capitalized labor costs that are treated as direct costs under Section 263A of the IRC allocable to that property, used by a taxpayer primarily in activities to manufacture a product for ultimate use in a JSF.

This bill would create a wage credit and a property credit for the VentureStar® spacecraft and VentureStar® launch site (VentureStar® credits) patterned after the JSF credits. The VentureStar® credits would apply to taxpayers under initial contract or subcontract to manufacture property for ultimate use in a VentureStar® spacecraft or launch site. Any excess credit could be carried forward for up to eight years. No credit would be allowed unless the bid upon which the VentureStar® contract or subcontract is based is reduced by the credit amount. The taxpayer would be required to provide, at the request of the Franchise Tax Board, all references to the credit and ultimate cost reductions incorporated into any successful bid that was awarded a VentureStar® contract or subcontract.

The wage credit would be equal to a specified percentage (50% for 2001, 40% for 2002, 30% for 2003, 20% for 2004 and 10% for 2005) of employee wages that are treated as direct costs under Section 263A of the IRC allocable to property manufactured in this state for ultimate use at a VentureStar® launch site located in California or in the manufacture of a VentureStar® spacecraft in California. The wages could be paid to new or existing employees whose services for the taxpayer are performed in California and at least 90% directly related to the contract or subcontract to manufacture property for ultimate use in VentureStar®

in California. The credit would be limited to $10,000 per year, per employee, and would be prorated for partial years.

The property credit would be equal to 10% of the cost of qualified property. Qualified property would mean tangible personal property (IRC Section 1245(a)(3)(A)), and capitalized labor costs that are treated as direct costs under Section 263A of the IRC allocable to that property, used by a taxpayer primarily in activities to manufacture a product for ultimate use in a VentureStar® spacecraft or launch site in California.

Certain types of property would be excluded from the definition of qualified property, including furniture, inventory, equipment used to store finished products that have completed the manufacturing process, and tangible personal property used in administration, general management, or marketing. The bill would provide special rules for costs paid pursuant to a binding contract and leased property.

The credit would be recaptured if, within one year of being placed in service, the property is sold, moved out of state or used for purposes other than manufacturing a product for ultimate use in a VentureStar® spacecraft or launch site.

The taxpayer would not be allowed this credit and the MIC for the same property.

POLICY CONSIDERATIONS

This bill would raise the following policy considerations.

- This bill would allow taxpayers located within an enterprise zone to claim the VentureStar® credits and an enterprise zone credit (e.g. sales or use tax credits and hiring credit) based on the same expenditure or wage. The enterprise zone credit provisions do not restrict the taxpayer to one credit based upon a single investment or employee.

  In addition, the wage credit and the qualified property credit overlap since capitalized labor costs that are treated as direct costs under Section 263A of the IRC would be eligible for both credits (plus any existing credits that do not contain provisions restricting the taxpayer to one credit based on a single investment or employee).

- Conflicting tax policies come into play whenever a credit is provided for an expense item for which preferential treatment is already allowed in the form of an expense deduction or depreciation deduction. This bill would have the effect of providing a double benefit for that expense item. On the other hand, making an adjustment to limit deductions or reduce basis in order to eliminate the double benefit creates a state and federal difference, which is contrary to the state’s general conformity policy.

- Generally credits are designed to encourage specific behavior in the taxpayer. For example, the MIC is meant to encourage manufacturers to choose California as the site for their manufacturing activities.

Information on the Venturestar® website makes it appear that decisions regarding the spacecraft and launch site have already been made.

Implementation Considerations

This bill would require the taxpayer to be under "an initial" contract or subcontract to manufacture property for ultimate use in a VentureStar® spacecraft or launch site. It is unclear whether an "initial contract" could include modifications to that contract. This could lead to disputes between taxpayers and the department.

The requirement to reflect the credit in the bid does not require that the bid be reduced by the allowable credit, only that the bid reflect the credit. The meaning of that requirement must be clarified so the department can implement this bill in accordance with the author's intention.

Technical Considerations

Amendments 1 through 4 would change references from the JSF credits to the VentureStar® credits.

Amendment 5 would correct a reference to the MIC.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

Revenue losses for this bill over the initial three-year period are estimated to be as follows:

Fiscal Year Cash Flow Impact Income/Taxable Years Beginning On or After Jan. 1, 2001 $ Millions			
	2000-01	**2001-02**	**2002-03**
Property Credit	**(minor)**	**(3)**	**(3)**
Wage Credit	**(3)**	**(28)**	**(26)**
Total	**(3)**	**(31)**	**(29)**

This estimate does not take into account any change in employment, personal income, or gross state product that may result from this bill becoming law.

Tax Revenue Discussion

State revenue effects depend on the value of investment and wages paid in California as part of the VentureStar® project. This analysis assumes that credits could be claimed in the year in which the federal government disburses money under the VentureStar® program. The credits could not be taken on any investment for which MIC is being claimed. Otherwise, it is assumed that the credit would be in addition to any other credits/deductions currently allowed for such expenditures. These credits would be available only for VentureStar® contracts and subcontracts that specifically reflect the use of these credits.

The federal government budgeted $282.8 million for a precursor to the VentureStar® (the X-33) in 1999 (www.venturestar.com). In addition, NASA has set aside $760 million in out-year placeholder funds for launch system development (NASA appendix of the federal budget). This estimate assumes, therefore, that NASA will spend about $300 million annually on the VentureStar® program. Because the launch site for the VentureStar® is expected to be Edwards Airforce Base, this estimate assumes that approximately 80% of the work on the project would be performed in California.

Other assumptions include:

- 40% of all VentureStar® contracts would be spent on qualified investments.

- 40% of all VentureStar® contracts would be spent directly on wages of qualified employees. In addition, 40% of subcontracts for qualified investments would be spent on wages of qualified employees. However, because the credit would be limited to $10,000 per employee, it is estimated that the wage credit would be approximately 25% of total wages in 2001. As the structure of the credit changes, the credit as a percentage of total wages declines to just under 10% by 2005.

- As a result of regular tax liability and alternative minimum tax limitations, 70% of credits would be used in the year in which they are generated. The numbers in the table reflect credits used.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD’S
PROPOSED AMENDMENTS TO SB 85
As Introduced December 7, 1998

AMENDMENT 1

On page 2, line 32, strikeout “23636” and insert:

23638

AMENDMENT 2

On page 6, line 12, strikeout “23637” and insert:

23639

AMENDMENT 3

On page 12, line 34 strikeout “17053.36” and insert:

17053.38

AMENDMENT 4

On page 16, line 12, strikeout “17053.37” and insert:

17053.39

AMENDMENT 5

On page 21, line 28, strikeout “23049” and insert:

23649